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UNCLAS SECTION 01 OF 02 ZAGREB 000710

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SENSITIVE

EUR/SCE FOR CATHERINE WESTLEY, TREASURY FOR INTERNATIONAL AFFAIRS LARRY NORTON

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SUBJECT: CROATIA'S 2010 BUDGET; FAILS TO ADDRESS NEEDED

REFORMS

REF: ZAGREB 665

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**¶1.** (U) SUMMARY: The Croatian parliament passed PM Kosor's proposed \$25.3 billion 2010 budget draft December 2, with all coalition parties voting in favor. Increased spending for social payments and the public sector comprise the majority of the budget with cuts in Defense, Foreign Affairs and other line ministries. The budget assumes low but positive GDP growth and rising VAT revenues next year, which, if accurate, will result in a budget deficit of 2.5 percent of GDP. Political opposition parties and most of Croatia's presidential candidates wasted no time in leveling criticism against PM Kosor for increased spending without substantive fiscal reform. Despite this criticism, the ruling HDZ party and its coalition partners defended the budget draft. The response from prominent economists has been skepticism of the government's optimistic GDP growth and revenue assumptions and exasperation over the lack of serious reform efforts. END SUMMARY

#### THE NUMBERS

**¶2.** (SBU) The GoC submitted its 2010 budget proposal to the Sabor November 21, with \$25.3 billion in expenditures and anticipated revenues of \$23.5 billion, resulting in a deficit of 2.5 percent of GDP. Social payments, pensions, and public sector salaries account for approximately 87 percent of the total budget. (Note: Both expenditures for salaries and pension payments increased 1.7 percent compared to 2009, and the overall 2010 budget is 1.5 percent higher than the 2009 budget). The GoC will spend 23 percent less on Defense expenditures in 2010 than in 2009, with minor cuts for Ministries of Foreign Affairs and Culture. The Croatian Sabor passed the budget draft December 2, with coalition parties in favor and the opposition against.

**¶3.** (SBU) The 2010 budget assumes GDP growth in 2010 of 0.5 percent. Finance Minister Suker explained that although revenues from business profit taxes and income taxes are lower overall, there has recently been an 11 percent increase in revenue from the value-added tax. The new budget relies heavily on the increased VAT for its revenue projections. The GoC raised the VAT to 23%, one of the highest in Europe, in July 2009, imposing an additional "crisis" income tax supplement at the same time. Additional funds to finance the deficit have been raised through a successful bond sale to European and U.S. investors this fall. The government has announced that the increased VAT and "crisis" income tax levied this summer will remain in place for the foreseeable

future.

¶4. (SBU) The GoC also forwarded to the Sabor budget projections for the next two years and a draft law on the execution of the budget, which would authorize the GoC to borrow \$6 billion in 2010 in order to finance due liabilities and the deficit.

#### POLITICAL OPPONENTS SCORE POINTS

¶5. (SBU) PM Kosor's critics in the opposition wasted no time criticizing the proposed budget. Opposition deputies raised strong concerns about Croatia's growing indebtedness, rising interest rates and also criticized Kosor for unfulfilled pledges of fiscal reform. Social Democratic Party (SDP) parliamentarians were the loudest critics, arguing for deeper fiscal reforms, including attrition of as much as one-third of government employees. The ruling Croatian Democratic Union (HDZ) and its coalition partners, however, closed ranks and defended the budget. In the midst of an on going presidential election, several of Croatia's presidential candidates also took the opportunity to score media points and criticized PM Kosor's leadership. Despite the loud and well-publicized criticism, none of the opposition parties, nor their presidential candidates, offered any specific alternative policy recommendations.

¶6. (SBU) Many prominent economists and financial analysts with private banks have expressed frustration with the 2010 budget. Unicredit bank's chief economist in Zagreb, Goran Saravanja, told us that the budget is no surprise and that there is no appetite to announce radical budget cuts in a presidential election season. Other prominent economists quoted in the media tend to agree. The general consensus is that Suker's optimistic revenue predictions for 2010 are unrealistic because of growing unemployment and weaker

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consumer spending. Several economists and opposition figures noted that, assuming revenue and spending forecasts are optimistic, a budget revision was likely to be needed as early as the first half of 2010.

#### COMMENT

¶7. (SBU) The 2010 budget reflects the political reality in Croatia, even at the expense of the fiscal one. The government and the ruling HDZ party simply do not have the political will at this time to make needed reforms and cuts in Croatia's public and social sector. Although political opponents have called the GoC out on this, there are no concrete proposals from the SDP or any other political parties for a realistic solution. Katarina Ott, the Director of the think tank Institute for Public Finance, put the necessary budget reforms in succinct terms at a conference last week: privileged pensions (such as those for war veterans) should end, the retirement-eligibility age should be raised from the current 49, younger pensioners should return to the labor market, and administration costs must be cut severely. Kosor and her new economic team understand that endless deficits and increased indebtedness cannot be sustained in the long run but there are no indicators to suggest that the GoC is going to adopt meaningful fiscal reform any time soon. Any chance that this anti-reform calculus could change will only come after the looming presidential elections on December 27 and January 10 are complete.

FOLEY